

# EXECUTIVE SUMMARY

It has been almost a decade since the *Transition Report* last looked in detail at the EBRD region's financial sectors. In that time, the global financial system has undergone major changes and nowhere have these changes been more profound than in the countries where the EBRD invests. This report looks at the evolution of finance in the transition region following the crisis of 2008-09 and considers the question of how finance should be rebalanced to provide more diverse and stable funding flows in support of economic development.

The report considers not only the quantity of finance but also its composition and quality. In many countries in the region, credit-fuelled boom-bust cycles have resulted in dual economies where some parts of the private sector are overindebted while others remain cut off from any access to credit or equity. This duality is reflected in the exceptionally high levels of non-performing loans (NPLs) compared with other emerging markets and advanced economies. Indeed, in half of the countries in the region NPLs exceed 10 per cent of total loans and 5 per cent of GDP. At the same time, many small and medium-sized enterprises (SMEs) are unable to finance their investment projects.

The four chapters in this *Transition Report* argue that the financial system needs to be rebalanced in a number of ways in order to provide more diverse sources of funding in support of growth. Equity financing, in particular, needs to play more of a role, so two of the chapters look in detail at the region's incipient private equity sector. These chapters highlight the special role that equity financing – and private equity capital in particular – can play in supporting investment, productivity increases and better management within firms. Thus, private equity could help to revitalise the transition process.

The need to shift from foreign currency-denominated finance to local currency credit markets is another priority. Seven years after the start of the financial crisis, the dollarisation

of credit in the region (that is to say, the percentage of lending denominated in a foreign currency) remains exceptionally high by global standards. On average, around 50 per cent of the total debt of households, firms and governments was denominated in a foreign currency in 2014. Successful rebalancing in this regard will require not only macroeconomic stabilisation, but also, in some countries, changes to banks' funding models, with shifts from foreign wholesale funding to domestic sources. Furthermore, investment finance in the region would benefit from more diverse capital flows and investment partnerships, with other emerging markets and non-European advanced economies playing a greater role.

Finance is a vast subject area and a document such as this cannot hope to cover all of it. This report is by no means exhaustive, nor does it necessarily focus on the largest areas of finance. Instead, it looks in detail at a few issues – such as bank finance for small businesses, private equity investment and the geographical diversification of sources of foreign direct investment – that illustrate the broader themes of the report.

The last part of the report examines recent economic developments in the region. Over the last year, the economic outlook for the transition region has been reshaped by a significant decline in oil prices, increased geopolitical uncertainty and the launch of a quantitative easing programme in the eurozone. However, despite this challenging economic and political environment, the outlook for market reforms appears to have improved. Assessments of economic developments and structural reforms in individual countries across the transition region are available online at [tr-ebd.com](http://tr-ebd.com).



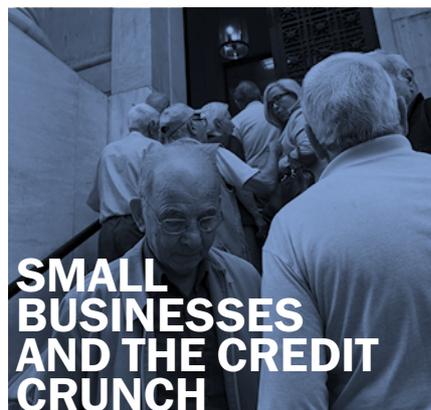
Prior to the financial crisis, a credit boom in the region boosted levels of investment and growth, but resulted in large and ever-increasing external imbalances financed by cross-border capital flows. With the crisis came a swift external adjustment, as cross-border capital flows declined dramatically and multinational banks withdrew funds from the region. That external adjustment has largely been successful, bringing domestic investment into line with the – predominantly low – levels of domestic savings. However, after years of sparse investment (compared with the levels observed in other emerging markets with similar characteristics) the region now has substantial investment financing needs, requiring an extra US\$ 75 billion per year.

Despite investment levels declining and firms in many countries facing a credit crunch, the region's overall indebtedness (measured as the sum of public and private debt, both domestic and external) has continued growing at approximately the same rate as before the crisis. In fact, indebtedness has increased by 25 percentage points of GDP since 2007, reaching 123 per cent of GDP in 2014. This reflects the substantial weakening of growth in nominal GDP, the revaluation of a large percentage of debt denominated in foreign currency, significant increases in public debt following efforts to stimulate the economy after the crisis and the fact that NPLs are weighing heavily on banks' balance sheets.

Notwithstanding those increases in the total level of debt, in some economies – particularly in central Europe, the Baltic states and south-eastern Europe – the ratio of domestic corporate debt to GDP remains below the levels that would be expected on the basis of those countries' per capita income, the strength of their economic institutions and other relevant characteristics. In other countries, however, scope for raising debt levels appears to be more limited.

In order to meet the region's vast investment needs, local financial systems will need to be rebalanced further. In countries where NPL levels are high, dealing with that overhang is a priority. In addition, a further shift towards local currency-denominated funding has the potential to reduce credit risk and improve the sustainability of debt. Looking beyond debt, increased use of equity instruments, measures to boost savings and the diversification of cross-border funding could all strengthen financial resilience, underpin investment and help to revive income convergence.

<http://2015.tr-ebrd.com/en/investment-gap>



This chapter uses a combination of macroeconomic, firm-level and bank-level data to gauge the extent to which firms across the transition region have become more credit constrained in the seven years since the onset of the global financial crisis. The analysis shows that while credit conditions for small businesses have tightened overall, there is substantial cross-country heterogeneity. Access to credit has deteriorated most in those countries that have experienced a decline in cross-border borrowing by banks, a decline in wholesale (rather than deposit) funding and/or a decline in bank leverage.

*Within* countries, the composition of local banking markets also plays a role. Analysis shows that when SMEs have a choice of various banks in their town or city, they tend to borrow from financially sound banks that have less hierarchical lending procedures, greater confidence in the quality of legal enforcement and a focus on establishing long-term lending relationships. This suggests that financial matters are not the only consideration in this regard and that organisational and institutional issues also have a key role to play in the debate about reviving lending to SMEs in the EBRD's countries of operations.

To stimulate SME lending, banks themselves can make additional efforts to streamline their loan application procedures. Surveys of firms reveal that many SMEs are discouraged from applying for credit by cumbersome and lengthy application procedures. The findings of this chapter also suggest that relationship banks have a special role to play as a stable source of SME finance. This highlights a potential downside of any short-term focus by banks (and their shareholders) on reducing the numbers of loan officers and other frontline staff who work directly with borrowers. Lastly, effective and efficient SME lending can also be stimulated by the establishment of well-functioning credit registries and decisive action to deal with NPLs, which are continuing to weigh on the balance sheets of many banks.

<http://2015.tr-ebrd.com/en/credit-crunch>



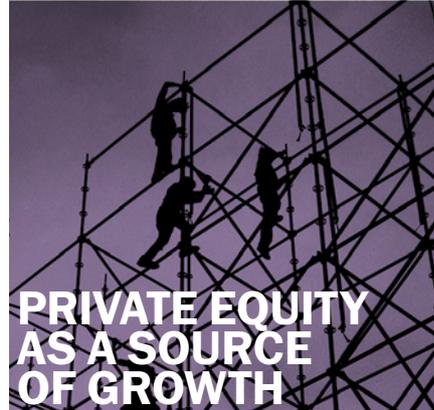
## TRENDS AND VALUE CREATION IN PRIVATE EQUITY

The private equity sector has grown steadily across the transition region over the last two decades, in terms of both the volume of assets that it manages and the impact that it has on local economies. However, private equity remains an underutilised source of external funding for companies in the EBRD region. This chapter considers how private equity funds could help contribute to more diverse financial infrastructure, thereby stimulating growth and efficiency improvements.

Prior to the crisis, the EBRD region accounted for close to one-fifth of all private equity capital invested in emerging markets. This share has recently dropped to less than one-tenth. Sluggish economic growth in the region has had a negative impact on returns on private equity investment. Cross-border deleveraging by parent banks present in the region and the resulting reduction in the availability of credit has also affected the investment strategies of private equity funds. The use of debt in private equity transactions – a common method of generating financial returns in advanced economies – has always been more limited in the transition region and has declined further since the global financial crisis. Instead, private equity funds focus more on implementing operational improvements in investee companies. This typically involves identifying companies with considerable growth potential, scaling up investments and sales, entering new markets and aligning company managers' interests more closely with those of shareholders.

An estimated US\$ 1 trillion remains available to private equity funds for investment in companies around the world. A more outward-oriented approach and greater emphasis on innovation could help companies in the EBRD region attract a larger share of those funds. Export activity increases the size of companies' markets, which is particularly important for firms in smaller economies with limited domestic growth potential. Meanwhile, innovative companies could attract venture capital – an area where the region lags behind other emerging markets.

<http://2015.tr-ebd.com/en/private-equity>



## PRIVATE EQUITY AS A SOURCE OF GROWTH

Private equity can be a useful source of external finance for companies. Perhaps more importantly, the active involvement of private equity fund managers can also assist investee companies to reach new customers, run operations more efficiently and improve their management of cash and inventories. Private equity support also tends to help companies to gain better access to credit.

The analysis in this chapter, and elsewhere in the report, shows that private equity investment in companies in the transition region has a positive effect on employment, capital investment and productivity. These positive effects, in turn, translate into higher levels of revenue and profit relative to similar companies that do not receive such investment. Furthermore, the results suggest that capital spending following private equity investment supports job creation. In contrast, capital expenditure and job creation tend not to coincide in advanced economies, where private equity funds typically target mature firms and focus on cutting costs and restructuring the labour force.

The number of companies in the region that have strong growth prospects and could potentially attract private equity investment is more than 10 times the number of companies that have actually received investment in recent years. Enabling more companies to attract financing from private equity funds could potentially generate additional employment and investment in the region.

Levels of private equity financing are sensitive to the region's growth prospects. Thus, a return to growth is likely to result in an uptick in private equity flows. However, policy-makers can also support such flows by strengthening the protection of minority shareholders, improving corporate governance and fostering the development of public equity markets. In addition, improving the enforcement of information disclosure rules can help shareholders to have a greater say in the management of companies. Meanwhile, the establishment of specialist stock exchanges for SMEs that reduce listing costs and the regulatory burden can improve access to equity financing. The latter can also make SMEs more attractive as investment targets for private equity funds, as they increase the likelihood of those funds exiting their investments with higher valuations.

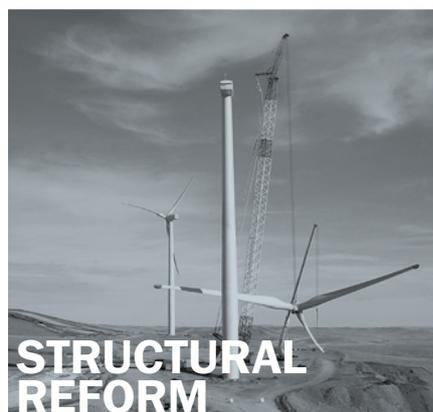
<http://2015.tr-ebd.com/en/growth-capital>



Over the last year, the economic outlook for the transition region has been reshaped by a significant decline in oil prices, increased geopolitical uncertainty and the launch of a quantitative easing programme in the eurozone. Although economic growth has picked up in many commodity-importing countries and is expected to strengthen further, average growth in the region has been weighed down by the negative shocks faced by Russia and other commodity exporters, and consequently, countries with strong economic ties to Russia.

As a result, the annual growth rate of the transition region as a whole is projected to decline for the fourth consecutive year in 2015, falling close to zero, before picking up moderately in 2016.

<http://2015.tr-ebrd.com/en/outlook>



While the political and economic environment remains challenging, the outlook for market reforms appears to have improved. There are opportunities for reform in many sectors and countries that would help to bring economic structures and institutions more into line with those of advanced market economies. Significant progress has been made with the enhancement of infrastructure in the last year, with cash-strapped governments increasingly realising the value of fostering private-sector involvement in the building and maintenance of transport links and municipal services. However, many transition countries still lag behind best practices when it comes to promoting the sustainable use of natural resources and economically inclusive growth.

<http://2015.tr-ebrd.com/en/reforms>